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In November 1978 the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Concepts No. 1 (SFAC #1), *Objectives of Financial Reporting by Business Enterprises.* The Statement represents the culmination of more than five years of work since the AICPA issued The Trueblood Committee report on the *Objectives of Financial Statements* in October 1973 (study group report).

The study group report received mixed reviews (Anton, 1976). Some were critical of the report pointing out its radical ideas, such as the reporting of current values when they were significantly different from historical cost, or the objective of providing financial forecasts when they would enhance the reliability of users' predictions. Others were more accepting of the report—at least as it pertained to objectives which appeared to be obvious. In light of these mixed reviews, it will be interesting to see the extent to which SFAC #1 is accepted by the accounting profession and other parties interested in the standard setting process.

SFAC #1 states that the purpose of Statements of Financial Accounting Concepts is to establish the objectives and concepts that the FASB will use as a basis for the development of financial accounting and reporting standards. The statements themselves will not establish generally accepted accounting principles. As a result, auditors' opinions will not be required to assess the conformity of financial statements with Statements of Financial Accounting Concepts.

This article compares the objectives as set forth in the study group report with those of SFAC #1. Similarities and differences are described and analyzed. The article also presents recommendations for continuing the work of the FASB in establishing the conceptual framework of accounting.

Background

The search for objectives can be traced back to the early 1960s when the AICPA published Accounting Research Studies Nos. 1 and 3, *The Basic Postulates of Accounting* (Moonitz, 1961), and *A Tentative Set of Broad Accounting Principles for Business Enterprises* [Sprouse and Moonitz, 1962]

Moonitz developed a framework of three tiers of postulates comprehending the environment within which accounting takes place, including the economic and political environment, the field of accounting itself and its characteristics, and the imperatives which were statements of a prescriptive nature. The postulates stressed what ought to be (goals, objectives, and standards).

Sprouse and Moonitz formulated a set of broad accounting principles that were compatible with the postulates set forth in ARS #1. Among the implications of these principles was that merchandise inventory and plant and equipment should be reflected in financial statements at current value. These findings, being at variance with accepted practice, were not supported by the profession.

In 1964 the American Accounting Association appointed a Committee to Prepare a Statement of Basic Accounting Theory [ASOBAT, 1966]. The Statement issued by the Committee stressed the information orientation of financial statements. That is, the primary objective of accounting is to satisfy the information needs of specific users of financial statements who are a diverse group with varied information needs. It is not necessary to know in detail the needs of all of these diverse users to prepare relevant reports for them since certain classes of information are relevant to many decisions.

In 1970, the Accounting Principles Board of the AICPA issued Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises.* The Statement was intended to provide a basis for enhanced understanding of the broad fundamentals of financial accounting. It was also intended to provide a basis for guiding the future development of financial accounting.

The statement proposes that the basic purpose of accounting is providing useful information for economic decision making. General and qualitative objectives aid in fulfilling this basic purpose and provide means for evaluating present and proposed accounting principles. General objectives provide long-range goals for the content of financial accounting consistent with environmental realities. Qualitative objectives describe in a general way the qualities of useful information.

The Statement was weak by its failure to elaborate on the information needs of users of financial statements. In an effort to overcome this weakness, in April 1971 the AICPA appointed a study group to develop a set of objectives of financial statements (study group report, 1973).

The main purpose of the study was to refine the objectives of financial statements. In seeking to do this, the study group was to consider the following:

Who needs financial statements?
What information do they need?
How much of the needed information can be provided by accounting?
What framework is required to provide the needed information?

The report stressed users' needs. It proposed that the accounting process should consist of an interrelated and compatible system of objectives, standards or principles, and practices or procedures. *Objectives* were to identify the goals and purposes of accounting. *Standards* followed logically from objectives and were to provide guidelines for the formulation of accounting *practices* compatible with the desired goals. All three levels of the system should be linked rationally to the needs of users. Objectives should consider environmental factors in addition to satisfying user information needs. Accounting as a dynamic discipline should evolve in response to changes in environmental conditions.

The basic objective of financial statements is seen as providing information that is useful for making economic decisions. The users of financial statements are parties external to the firm, such as investors and creditors (primary users) as well as government agencies, employees, and the general public.

Objectives should meet the needs of these user groups. However, little research has been conducted to determine the role of financial statements in the economic decision making process of statement users. On the basis of the lack of data on users' information needs, the study group made the following assumptions, supported by research, regarding the needs of statement users and the role of financial statements in the decision making process:

1. Users of financial statements seek to predict, compare, and evaluate the cash consequences of their economic decisions
2. Information about the cash consequences of decisions made by the enterprise is useful for predicting, comparing, and evaluating cash flows to users
3. Financial statements are more useful if they include, but distinguish, information that is primarily factual and therefore can be measured objectively from information that is primarily interpretive.

The remainder of the objectives are consistent with these assumptions and the objectives satisfy infor-

FIGURE 1
SUMMARY OF THE OBJECTIVES OF FINANCIAL STATEMENTS AS PRESENTED IN THE STUDY GROUP REPORT

Basic Objective:
To provide information useful for making economic decisions.

Subsidiary Objectives

1. To serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities.
2. To provide information useful to investors and creditors for predicting, comparing, and evaluating potential cash flows to them in terms of amount, timing and related uncertainty.
3. To provide users with information for predicting, comparing, and evaluating enterprise earning power.
4. To supply information useful in judging management's ability to utilize enterprise resources effectively in achieving the primary enterprise goal.
5. To provide factual and interpretive information about transactions and other events which is useful for predicting, comparing, and evaluating enterprise earning power. Basic underlying assumptions with respect to matters subject to interpretation, evaluation, prediction, or estimation should be disclosed.
6. To provide a statement of periodic earnings useful for predicting, comparing, and evaluating enterprise earning power. The net result of completed earnings cycles and enterprise activities resulting in recognizable progress toward completion of incomplete cycles should be reported. Changes in values reflected in successive statements of financial position should also be reported, but separately, since they differ in terms of their certainty of realization.
7. To provide a statement of financial activities useful for predicting, comparing, and evaluating enterprise earning power. This statement should report mainly on factual aspects of enterprise transactions having or expected to have significant cash consequences. This statement should report data that require minimal judgment and interpretation by the preparer.
8. To provide information useful for the predictive process. Financial forecasts should be provided when they will enhance the reliability of users' predictions.
9. To provide information for governmental and not-for-profit organizations useful for evaluating the effectiveness of the management of resources in achieving the organization's goals. Performance measures should be quantified in terms of identified goals.
10. To report on those activities of the enterprise affecting society which can be determined and described or measured and which are important to the role of the enterprise in its social environment.

mation needs of external users of financial statement as envisioned by the study group. A summary of the objectives is presented in Figure 1.

Objectives are affected by economic, political, social and legal considerations.

Based on the study group report, the FASB issued a discussion memorandum, "Conceptual Framework for Accounting and Reporting: Consideration of the Report of the Study Group on the Objectives of Financial Statements," dated June 6, 1974. On December 2, 1976, the Board issued its *Tentative Conclusions on Objectives of Financial Statements of Business Enterprises.*

The Board considered the objectives of financial statements in the study group report but did not attempt to reach conclusions on some of them—for example, reporting current value and changes in current value, providing a statement of financial activities, providing financial forecasts, determining the objectives of financial statements for governmental and not-for-profit organizations, and reporting enterprise activities affecting society [SFAC #1, p. 30]. In September, 1979 the Board issued a statement on supplementary disclosures of the effects of changing prices on business enterprises [SFAS Statement No. 33]. The Board also has a project on objectives of financial reporting by organizations other than business enterprises. An exposure draft, "Objectives of Financial Reporting by Nonbusiness Organizations," was issued in March, 1980.

The Board issued an exposure draft of a proposed statement of financial accounting concepts ["Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises," December 29, 1977]. The first statement of concepts by the Board [SFAC #1]limited the subject matter to the objectives. The Board issued a revised exposure draft on "Elements of financial statements of business enterprises," in December 1979 and an exposure draft "Qualitative characteristics" in August 1979. A summary of the objectives is presented in Figure 2.

FIGURE 2
SUMMARY OF THE OBJECTIVES OF FINANCIAL REPORTING AS PRESENTED IN SFAC #1

Basic Objective:
To provide information that is useful in making business and economic decisions.

Subsidiary Objectives:

1. To provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activity and are willing to study the information with reasonable diligence.

2. To provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.

2. To provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.

3. To provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities, and owners' equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources.

4. To provide information about an enterprise's financial performance during a period and about how management of an enterprise has discharged its stewardship responsibility to owners. The information, as provided by measures of earnings and its components, should, to the extent possible be useful to present and potential investors and creditors and others in (a) evaluating management's performance, (b) estimating "earning power," (c) Predicting future earnings, or (d) assessing the risk of investing in or lending to an enterprise.

5. To provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise resources to owners, and about other factors that may affect an enterprise's liquidity or solvency.

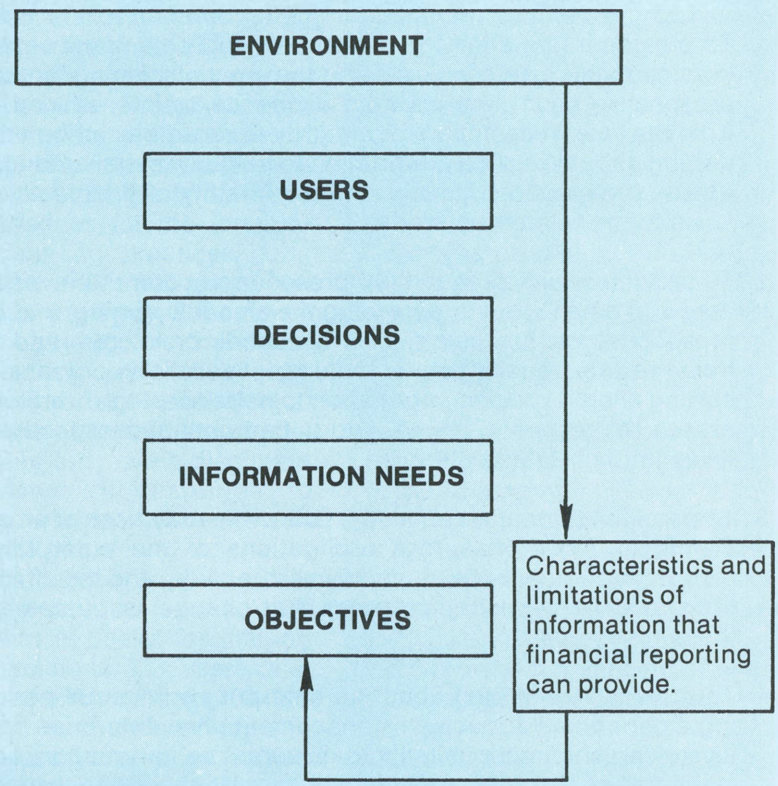
6. To provide information that is useful to managers and directors in making decisions in the interests of owners.

7. To include explanations and interpretations to help users understand financial information provided.

Environmental Context of Objectives

The study group report and SFAC #1 both use the framework illustrated in Figure 3 as the foundation for the development of objectives. The ideas expressed in the literature described earlier were instrumental in the establishment of this framework.

Figure 3



Objectives are affected by economic, political, social, and legal considerations. Objectives cannot be established in a vacuum but must be responsive to the broad environment of financial reporting and must adapt to changes in that environment.[1]

The users of financial information and the information needed by them for decision making purposes are determined from the environment. These, in turn, determine the objectives. However, the objectives may need to be modified because of characteristics and limitations on the information that financial reporting can provide.

Similarities

There are many areas of similarity between the study group report and SFAC #1. While the objectives are directed toward the common interests of a diverse group of users, there is agreement that the primary users are investors and creditors since they provide much of the needed funds to carry on business operations. Other users include suppliers, customers, employees, management, financial analysts and advisors, regulatory authorities, and the general public.

The objectives focus on meeting the information needs of present and potential investors and creditors as the primary users of financial reports. The information needs of other users can generally be met concurrently.

Investors need information which helps them to decide whether to buy, sell, or hold investments. Creditors need information which helps them to decide whether to lend funds to the business enterprise. In order to make these decisions, investors and creditors seek information which helps them assess the amount, timing, and uncertainty of cash flows they receive. These flows are in the form of interest and dividends. In addition, investors are concerned with their prospects for capital appreciation while creditors are concerned with the ability of the enterprise to repay loans when due.

The objectives relate to general purpose external financial reporting by business enterprises. The study group report and SFAC #1 recognize as the primary objective the provision of information useful for decision making. In addition, both agree that the information provided should be useful to investors and creditors in assessing the amounts, timing, and related uncertainty of prospective cash flows. Therefore, an objective of reporting is to provide users with information for evaluating the earning power of the enterprise, its financial position as indicated by its economic resources, claims to them (obligations and owner's equity), the effects of transactions, events, and circumstances that change its resources or claims to them and the effective utilization of enterprise resources by management (stewardship responsibility).

Other similarities include: the use of accrual accounting as the primary basis for measuring earnings, and a clear reference that financial accounting is not designed to measure directly the value of a business enterprise but the information provided may help in this endeavor.

Finally, it is recognized that investors and creditors may want to use the information provided to estimate earning power, predict future earnings, assess risk, or evaluate earlier predictions. Financial reporting provides information on past transactions and events (historical information) which may be useful in making these evaluations. However, this is not an objective of financial reporting. There is some disagreement on this point. The study group report

Objectives should consider environmental factors in addition to satisfying user information needs.

recognizes as an objective the provision of information useful for prediction. SFAC #1 recognizes this as a by-product of financial reporting. Investors and creditors are thought to do their own evaluations with the information provided by financial reports. In summary the similarities are study report objectives 1-6 and SFAC objectives 1-5.

Differences

The difference between the study group report and SFAC #1 can be grouped into two categories: (1) objectives included in the study group report but not covered in SFAC #1, and (2) objectives included in SFAC #1 but not covered in the study group report.

Objectives not covered in SFAC #1

The biggest difference between the study group report and SFAC #1 pertains to the context of the objectives. The study group report deals with objectives of financial statements while SFAC #1 focuses on objectives of financial reporting. This difference is a very significant one.

The study group report detailed the financial statements necessary to accomplish the objectives it set forth and the types of information that should be included in the statements. There should be a Statement of Financial Position, a Statement of Periodic Earnings, and a Statement of Financial Activities. These statements should provide factual and interpretive information, and information useful for predictions, comparisons, and evaluations.

In SFAC #1 a distinction is made between financial statements and other forms of financial reporting. Financial statements are viewed as only one of the many forms of financial reports that can be provided to users. It is expected that users will look to sources other than financial statements for some of their information needs. These sources might be corporate annual reports, prospectuses, and reports filed with the SEC. These reports include not only financial statements but other financial and non-financial information, such as news releases, management's forecasts or other descriptions of its plans of expectations, and descriptions of an enterprise's social or environmental impact. These reports present information other than that presented in financial statements.

In drawing a sharp distinction between financial statements and other forms of financial reporting, it appears that the FASB was trying to overcome some of the criticisms expressed about the study group report. The report established as part of the objectives of financial statements:

> The provision of information on current values when they differ significantly from historical cost
>
> The provision of forecasts when they would enhance the reliability of users' predictions
>
> The provision of information useful for evaluating the effectiveness of the management of resources in achieving the goals of governmental and not-for-profit organizations.
>
> The reporting on those activities of the enterprise affecting society which can be determined and described or measured and which are important to the role of the enterprise in its social environment

The intent of the Board appears to be to establish objectives for a variety of forms of financial reporting by business enterprises. While financial statements are viewed as the principal means of communicating accounting information, no conclusions are reached about the identity, number, or form of financial statements because those matters are yet to be considered in the conceptual framework project.[2]

The distinction between financial statements and the broader concept of financial reporting is a useful one. The study group report created an impression that the financial statements should include information which was generally thought to be in the purview of general purpose financial statements, such as current value information and information on financial forecasts. SFAC #1 does not draw any conclusions about either of these two.

Objectives provide means for evaluating present and proposed accounting principles.

However, some questions are raised as well. Since the objectives are those of financial reporting, shouldn't the next step in the conceptual framework project be to clearly define and distinguish the types of financial statements and other forms of financial reporting envisioned? Shouldn't the next step include a discussion of how the financial statements and other forms of financial reporting will help to achieve the objectives set forth? Instead, the Board is dealing with the elements of financial statements in its next phase of the conceptual framework project. In summary the objectives included in the study group report but not covered in SFAC #1 are Nos. 7, 8, 9, and 10 as presented in Figure 1.

Objectives not covered in the study group report

The objectives presented in both the study group report and SFAC #1 are quite broad in scope. These objectives may need to be modified by certain characteristics and limitations of information that financial reporting can provide. The characteristics and limitations directly affect the objectives. Some are readily apparent from the study group report, for example, the need to approximate, estimate, and make judgments in reporting financial information. In SFAC #1, however, some of the burden for the provision and usage of financial information for decision making has been placed on management, who act on behalf of the users, and on the users themselves. For example, the Board states that:

> managment knows more about the enterprise and its affairs than investors, creditors, or other "outsiders" and accordingly can often increase the usefulness of financial information by identifying certain events and circumstances and explaining their financial effects on the enterprise.

This is in keeping with the broader notion that there are financial reports that can provide very useful information which can't be provided by conventional financial statements.

There is general agreement that the information presented in financial reports should be comprehensible to users. The study group report states that:

> an objective is to serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statement s as their principal source of information about an enterprise's economic activities.

SFAC #1 states that:

> the objectives stem primarily from the needs of external users who lack the authority to prescribe the information they want and must rely on information management communicates to them

However, this information, according to SFAC #1:

> should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence

This is a much needed definitive statement of the limits of the usefulness of financial information. The degree of complexity of such information, especially when viewed within the broader context of financial reporting, requires that an effort be made by the user to become familiar with the nature, content, and form of presentation of financial information.

Other characteristics and limitations of financial reporting presented in SFAC #1 elaborate on the theme that financial reports cannot be expected to fulfill all the information needs of users. For example, there is a cost involved in providing information for financial reporting purposes. The benefits derived from the information should be equal to or greater than the cost involved. Therefore, there is a cost-benefit tradeoff which might lead to the exclusion of some information from financial reports.

Information provided should be useful in assessing the amounts, timing, and related uncertainty of prospective cash flows.

Finally, even the broad notion of financial reporting does not encompass all the information needs of the users. Those who rely on financial information for their decision making needs should incorporate information provided by financial reports with pertinent information from other sources, for example, general economic conditions or expectations, political events, and political climate, or industry outlook.

In addition to the characteristics and limitations described above, the greater burden placed on management and the users by SFAC #1 is indicated by objectives 6 and 7 in Figure 2 but are not covered in the study group report.

Summary and Conclusions

SFAC #1 overcomes many of the criticisms voiced against the study group report. However, this has been accomplished primarily by excluding controversial topics from the purview of their statement. SFAC #1 does not deal with governmental and not-for-profit reporting and the use of current values in financial statements. This is quite appropriate since both issues are currently under separate study by the Board. Also, SFAC #1 does not deal with financial forecasts and social reporting. These are important issues which should be discussed especially when viewed in the context of financial reporting as envisioned by the Board in the establishment of its objectives.

The Board has made progress in defining the limits of information provided by financial reporting. Financial reports cannot be understood by users unless they are willing to make an effort to educate themselves about the information being presented. Management has a responsibility to help users better understand the financial information presented to them. The accounting profession must continuously strive to increase the understandability of financial reports.

Conventional financial statements cannot be expected to provide all the information that decision makers need. Users must look to sources other than the financial statements. Consequently, management has an important role to play by identifying important events and by providing explanations of their financial effects on the enterprise.

The benefits derived from the information should be equal or greater than the cost involved.

There are many similarities between the study group report and SFAC #1. General agreement exists on the basic objective, the users, and the information that should be provided to meet their decision making needs. In this respect the FASB has brought to a conclusion the work begun by the Trueblood Committee over five years ago. The Committee felt that its conclusions should be viewed as an initial step in developing objectives. in SFAC #1 the Board has refined and clarified many of these objectives.

On the other hand, SFAC #1 opens up a whole new area of concern. There should be a clear definition of financial reporting and the role of financial statements in this context. The Board decided to leave this to later stages of the conceptual framework project. The next phase will focus on defining the elements of financial statements.

A gap exists between the objectives stated in SFAC #1 and their implementation. The next logical step in the evolution of a conceptual framework of accounting would be to close that gap by defining the financial statements and other forms of financial reporting required to provide the information, as described in SFAC #1, to meet the decision making needs of the users of financial reports. Ω

NOTES

[1]The descriptive characteristics of the economy of the U.S. provide the foundation for developing objectives. These characteristics include, among others: highly developed exchange economy; use of money as a medium for exchange; consumption, saving, and investment activities in the economy; aidespread form of investor-owned business enterprises; need for funds to carry out business operations; utilization of national and/or multinational markets to raise needed funds by selling stock and/or borrowing money; private ownership of productive resources; diversity of markets ranging from highly competitive to regulated monopolies; and periodic government intervention in the process of allocating resources.

[2]SFAC #1 identifies the financial statements now most frequently provided as (a) Balance Sheet or Statement of financial Position, (b) Income or Earnings Statement, (c) Statement of Retained Earnings, (d) Statement of Other Changes in Owner's or Stockholders' Equity, and (e) Statement of Changes in Financial Position (Statement of Source and Application of Funds).

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the auditor turns to the next chart which outlines the "remedy" suggested by the auditor, such remedy having been developed in concert with auditees involved during the review. If general agreement is obtained, the auditor moves on to the next finding. However, if the auditee does not agree with the suggested remedy, a viable alternate solution is sought. Should agreement for a remedy become unattainable, the auditor collects enough information to reflect fairly significant views in the final report. It is the auditor's responsibility, however, to take a position and to state that position after considering all relevant viewpoints and facts.

8. After all findings are reviewed, the auditor summarizes the findings using one chart, and then "talks through" the proposed corrective action. The discussion is limited, but presented in such a manner to avoid any misunderstandings as to the findings and suggested remedies.

Summary

In conclusion, to conduct a post audit review meeting that promotes understanding, one must:

1. Include department heads.
2. Conduct meetings on neutral ground.
3. Restrict meeting time to one hour or less.
4. Avoid an air of confrontation.
5. Encourage auditee input.
6. Use visual aids to highlight the findings, the impact, and the remedies.
7. Obtain concurrence with auditees, or failing that, fairly reflect varying views while still making an independent audit decision as to the position taken.

It is helpful to keep in mind that internal auditing is a management service conducted by professionals. The ultimate success of the audit depends upon the auditor's ability to promote effective action to remedy substantive problems. Ω

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